

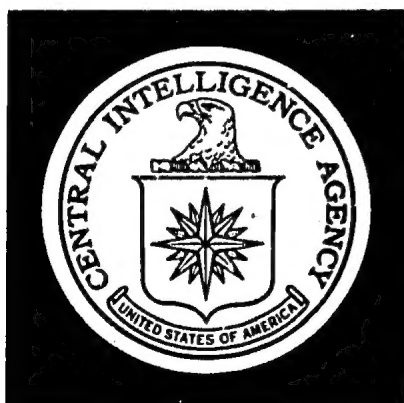
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DIRECTORATE OF  
INTELLIGENCE

# Intelligence Memorandum

*The Economic Outlook for Peru and the IPC Dispute*

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CENTRAL INTELLIGENCE AGENCY  
Directorate of Intelligence  
March 1969

## INTELLIGENCE MEMORANDUM

The Economic Outlook for Peru  
and the IPC Dispute

Summary

Peru's dispute with the United States over the expropriation of the International Petroleum Company (IPC) seriously threatens Peruvian economic growth during the next several years. If Peru does not take steps by early April of this year to compensate the IPC for the properties taken over last October, it will lose a large part of its US aid. In this event, private foreign investment in Peru would be reduced, and drawings on credits from international financial institutions might suffer a large decline over a period of several years. The adverse impact on Peru's receipts of foreign capital and thus on the rate of economic growth would be still greater if the military government retaliated against the United States by expropriating additional US investments.

Invocation by the United States of the Hickenlooper and Sugar Act amendments because of the IPC issue would reduce US aid to Peru by between \$45 and \$55 million in 1969, would cause it to lose some assistance from other sources, and would discourage private foreign investment at least temporarily. As a result, Peru probably would achieve little or no growth in total output in 1969, unless it took compensating measures. Restrictions on profit remittances by foreign businesses in Peru could help in maintaining its capacity to import, since these profits now amount to about \$90 million annually. Even

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if Peru took this step, total Peruvian output could not be expected to rise by more than 1 or 2 percent in 1969 because of the restrictive effects of the government's financial stabilization program. Such a rate of growth would mean a small decline in output per capita because Peru's population is rising by 3 percent annually.

If Peru initiated steps to compensate IPC during the next year or so, a gradual recovery of economic growth could be expected in the early 1970's. If US sanctions remained in force throughout the early 1970's, however, the country's economic performance would not be very satisfactory. With the cutoff of virtually all inflows of foreign capital from customary channels, the expansion of Peru's import capacity during the period would be small, and the rate of economic growth probably would be scarcely high enough to match the increase in population.

In these circumstances, Peru probably would seek assistance from such Free World countries as Japan and France and from the Communist countries. Efforts to obtain assistance from other Free World countries are likely to have little success because Peru's international credit rating would be damaged by the sanctions. The USSR and other Communist countries probably would offer economic credits, but large-scale utilization of credits from these sources by Peru seems unlikely because of its fundamentally Western orientation.

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**SECRET**Economic Dispute with the United States

1. The first major act of Peru's new military government, which ousted the Belaunde administration in October 1968, was to seize the main producing assets of the IPC. In so doing, the new leaders nullified the Act of Talara, under which the Belaunde government and IPC had reached agreement regarding IPC's future operations in Peru. IPC's ownership of the La Brea y Parinas oil deposits had long been a major focus of nationalistic irritation.\* Prior to his election in 1963, Belaunde pledged to settle the IPC question within 90 days -- a pledge finally redeemed in August 1968 with the Act of Talara. As the terms of the settlement became known, many Peruvians felt that the government had not obtained sufficiently large concessions from IPC, and nationalistic dissatisfaction with the settlement became increasingly strong.

2. General Juan Velasco Alvarado, who led the takeover, capitalized on this nationalism by using the unpopular Act of Talara as a pretext for the coup. Six days after the coup, he further strengthened his popular support by seizing the IPC properties. Velasco has kept the IPC issue in the public spotlight and seemingly has foreclosed any settlement of the dispute. The remaining IPC properties were seized in January and February 1969 for an alleged nonpayment of debts to Peru for oil products supplied from the expropriated refinery. On 6 February, Velasco set IPC's debt to the state -- against which the value of the expropriated assets is to be deducted -- at \$690 million. This amount represents the value (less the direct costs of production) of petroleum products "illegally" obtained from IPC's properties since 1924. In order to contest this claim in Peruvian courts, IPC apparently must first pay it.

Economic Setting

3. Peru's difficulties with the United States over the expropriation of the IPC come at a time of

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economic recession, following a long period of rapid economic growth. During 1961-66, gross domestic product (GDP) grew an average of 6.3 percent annually, the highest rate in South America. In the 1950's and early 1960's, growth was sparked by sizable direct foreign investments and by a rapid expansion of fishmeal and minerals exports. After 1962, growth was fueled mainly by large investments financed to a considerable extent by international lending institutions and private foreign banks.

4. As the economic advance continued, strains began to develop. Sluggish government revenues led to budgetary deficits and increasing inflation, and the balance of trade worsened after 1964, as exports stagnated. The failure of the Belaunde government to resolve its budgetary problems led in early 1967 to a loss of business confidence and a substantial capital flight. A 31-percent devaluation of the sol in September 1967 improved the trade balance, but political obstacles to the achievement of budgetary balance further eroded business confidence, and the capital flight continued. Reduced investment and a drought-induced drop in agricultural production slowed the rate of growth of GDP to 5 percent in 1967.

5. In mid-1968 the Belaunde government began a strong attempt at financial stabilization with the aid of special powers granted by the Congress. Belaunde was deposed before the results of the program became apparent. The military government, continuing this program, has (a) cut government expenditures and imposed new taxes, (b) obtained a \$75 million standby credit from the International Monetary Fund (IMF), (c) refinanced some \$150 million in debt service payments falling due to private US and European banks during 1968-69, and (d) increased pressure on the US-owned copper companies to proceed with planned investments totaling more than \$600 million over the next several years. The stabilization program appears to have achieved some success under the new regime. The rise in the cost of living, which amounted to 23 percent from mid-1967 to mid-1968, has stopped, and a large favorable balance of trade was achieved in 1968. Most of this improvement, however, was gained at the expense of a sharp curtailment of imports of

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capital goods, a decline in investment, growing unemployment, and a further slowing of economic growth. The increase in GDP for 1968 amounted to only about 2 percent.

6. At best, Peru faces a period of austerity and fairly slow growth over the next year or two while basic readjustments are made to bring government revenues and expenditures more nearly into balance. Even if the IPC issue did not threaten to bring about a reduction in Peru's receipts of foreign capital, the economy would not be expected to achieve a growth rate of more than 2 or 3 percent in 1969. Restoration of more rapid growth rates depends largely on an expansion of tax revenues and export earnings, which in turn require large foreign investments in copper and other mining projects.

#### Threatened Ending of US Aid to Peru

7. If Peru does not take steps by early April to provide adequate compensation to IPC for the producing properties and refinery that it expropriated six months earlier, it will lose a large part of the aid that it has been receiving from the United States. The US government will be required by the Hickenlooper amendment to the Foreign Assistance Act and similar amendments to the Sugar Act to terminate certain types of economic aid, all military assistance, and the country's quota for sugar exports to the US market. Similar legislation will require the United States to use its veto power to deny new loans to Peru from the Social Progress Trust Fund and the Fund for Special Operations, which are administered by the Inter-American Development Bank (IDB). Disbursements on existing loans from these funds probably would continue, however. In addition, the Export-Import Bank might refrain from extending any new credits for investments in Peru, and the United States might reduce or end certain other types of aid even if such action were not required by law.

#### Amount of US Aid at Stake

8. Although US-Peruvian relations have been strained in recent years, Peru has continued to receive substantial amounts of US aid. Scheduled



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disbursements of all types of US aid in 1969 probably amounted to between \$70 and \$80 million before the IPC dispute came to a head. Unless the issue is resolved, Peru probably will lose between \$45 and \$55 million in US aid in 1969 and even more in succeeding years.

9. If the IPC problem had not arisen, Peru probably would have received about \$15 million in development loans and technical assistance through the Agency for International Development (AID) in 1969, compared with some \$25 million in both 1965 and 1966. The United States has not authorized any new development loans for Peru since July 1967, because of Peru's purchase of Mirage jet aircraft from France and the subsequent passage of the Symington and Conte-Long amendments. During 1968, however, the United States disbursed \$8 million under development loans negotiated before July 1967. About \$37 million in authorized loans for development projects remains in the pipeline, about \$10 million of which had been scheduled for disbursement in 1969. Technical assistance has continued despite the strain in US-Peruvian relations. Under normal circumstances, technical assistance in 1969 would amount to about \$5 million -- the level of the past several years. Military assistance grants from the United States have averaged about \$10 million per year since 1961.

10. Since 1961, "soft" loans amounting to about \$120 million have been authorized for Peru by IDB's two special funds, which are supported wholly by the United States. About \$70 million in loans from these two funds remains undisbursed. Scheduled disbursements under these loans would not necessarily be affected by US sanctions against Peru, but US vetoes of new loans would eventually reduce disbursements from their current level of some \$10 million annually.

11. Peru's export quota of 354,000 short tons of sugar for the US market in 1969 involves a prospective subsidy of about \$25 million. This element of US aid to Peru reflects the difference between the value of the exports at the price received from the United States (about 6.5 cents per pound) and the value at the world market price, which is expected to be about 3 cents per

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pound in 1969. By early April, Peru probably will have shipped about 35 percent of its US quota for 1969. Application of the Sugar Act amendment thus would probably reduce Peruvian export earnings by about \$16 million (or 2 percent), provided that Peru could find alternative markets for its sugar.

12. The Export-Import Bank also is an important source of credits for economic development in Peru. During 1961-68, Peru received credit extensions totaling about \$120 million from this source. Eight loans are active at present; these total \$68 million, of which \$27 million remains undisbursed. The US copper companies in Peru have been counting on the Bank to finance a large portion of the \$600 million cost of their planned expansion program. Under Title II of Public Law 480, Peru has been receiving surplus US agricultural commodities valued at about \$6 million annually. If the foreign aid amendments are invoked, the US might also stop insuring private US loans for housing construction in Peru. Private funds amounting to some \$5 million annually have been flowing to Peru under the Housing Guarantee Act; \$3.5 million is scheduled to be disbursed during the remainder of 1969.

Impact of US Aid Suspension on Other  
Inflows of Capital

13. Suspension of aid to Peru by the United States probably would in time bring a sharp reduction in the sizable amounts of capital that Peru has been receiving from international financial institutions. The prospective decline in receipts of capital from the United States probably would create conditions that would prevent Peru from making further drawings on its standby credit of \$75 million from the IMF, only \$42.5 million of which will have been used by May. During 1961-68, Peru received credit extensions averaging about \$20 million annually from the World Bank and the regular loan funds of the IDB. About \$70 million in credits from these two sources remains undisbursed.\* The World Bank has a long-established

\* This amount is in addition to the \$70 million of undisbursed credits from the two special funds administered by the IDB.

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policy of deferring action on loans to a member engaged in a dispute with another member. Although disbursements from IDB's regular funds might continue for projects already under way, the dominant position of the United States in the IDB would make extension of new credits to Peru unlikely unless the US government raised no objection.

14. If US aid were suspended, bankers and exporters in the United States and Western Europe probably would defer new development loans and suppliers' credits for at least six months while they assessed Peru's reaction to the loss of aid. Bankers probably would provide some money, however, for projects already under way and would refinance existing debts, since the alternative might simply be default by Peru. Private direct investment in Peru by foreign enterprises would be likely to be held in abeyance for six months or more. Short-term financing of Peru's foreign trade would continue, though perhaps on a reduced scale.

Options Open to the Peruvian Government

15. Although the new Peruvian leaders apparently thought for a time that the United States was bluffing, at least some of them now understand that the Hickenlooper and Sugar Act amendments probably will be invoked. Peru's reaction to the loss of US aid could range from calm resignation to drastic retaliatory measures. Peru's most effective low-key response would be to restrict the remittance of profits by US and other foreign businesses. The bulk of this outflow of funds could be blocked either through exchange controls or through imposition of heavy new taxes on the profits of foreign firms, which would have the added advantage of helping to balance the budget. Foreign companies in Peru earn about \$90 million annually and normally repatriate a large part of their profits. Peru could restrict this outflow sufficiently to largely offset the prospective decline in receipts of capital from official sources. This action probably would not precipitate a large-scale flight of capital from Peru because (a) Peruvian banks are not sufficiently liquid to support a large-scale flight of capital, (b) the Peruvian government would take measures to restrict large transfers of funds to other countries, and

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(c) some investors transferred large sums abroad in 1967 and early 1968 in response to Peru's uncertain economic prospects.

16. To retaliate against the United States for cutting off aid, the Peruvian government also could take the extreme, shortsighted step of expropriating some or all of the remaining US investments in Peru, which have a book value of about \$600 million and a probable market value of about \$1.5 billion. These investments are located in all sectors of the economy -- mining, agriculture, manufacturing, shipping, commerce, communications, and banking. Among the more important investments are those of the Cerro Corporation (copper) and Southern Peru Copper Company, the Belco Petroleum Corporation, W.R. Grace and Company (sugar, textiles, chemicals, banking, and shipping), and the International Telephone and Telegraph Company. Although Peru and the United States have signed a specific risk investment guaranty agreement in regard to the convertibility into dollars of earnings of US companies in Peru, there is no guaranty agreement covering expropriation.

17. The Peruvian regime already has taken steps to broaden economic contacts with Communist countries, continuing the policy initiated by Belaunde. Peru has not traded with the USSR since 1963, and its trade with the Eastern European countries amounted to only \$21 million in 1967 (or 1½ percent of the Peruvian total). Since the coup, Peru has established diplomatic relations with Rumania, Czechoslovakia, Yugoslavia, and the USSR and has signed trade agreements with Rumania, Czechoslovakia, Poland, and the USSR. Most of these agreements have called for increased trade, without setting specific goals, and have been accompanied by offers of export credits to Peru. Peru has expressed interest in importing farming, manufacturing, mining, and oil-field equipment, and the USSR appears to be willing to buy various Peruvian commodities (but not sugar).

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At present an official Peruvian delegation is in Communist China to arrange a purchase of rice and try to develop a market there for Peruvian exports. Major efforts to expand trade with Western Europe and Japan also would be an obvious response to deteriorating relations with the United States.

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Economic Outlook for 1969

18. The prospect that US economic sanctions will be applied in April is already having a detrimental effect on the Peruvian economy. The pace of foreign investment has slowed in recent months. The large US mining companies, for example, are awaiting developments before continuing with their planned investment programs. Moreover, US commercial banks are attempting to reduce their outstanding loans to Peru, and a clandestine flight of capital appears to be under way. Commercial bank deposits fell sharply in January and continued to decline in early February. Activity has increased in the nonregistered foreign exchange market, where nervous investors have been willing to pay a premium to avoid having their purchases of dollars reported to the government. In addition, the IMF has reported a \$15 million loss of foreign exchange by Peru during January and early February.

19. In itself, the prospective reduction in US aid probably would halve the 2 to 3 percent rate of economic growth expected for Peru in the absence of the dispute over the IPC. Since some aid would already have been delivered and some funds probably would be provided by the Export-Import Bank for projects in process, Peru would lose only an estimated \$45 to \$55 million this year. Moreover, the amount withdrawn from the flow of expenditures would be somewhat smaller than the amount of aid lost, because the technical assistance funds are spent largely in the United States and part of the sugar subsidy presumably is remitted as profit by W.R. Grace and Company, Peru's second largest sugar producer.

20. Peru's receipts of capital from the Social Progress Trust Fund, the Fund for Special Operations, the general loan fund of IDB, and the World Bank probably would not be affected materially in 1969 because disbursements under loans already authorized would continue. Loss of the remainder of the standby credit from the IMF and reduction of direct private investment -- added to the loss of US aid -- probably would result in little or no growth in total Peruvian output in 1969, unless profit remittances were reduced greatly.

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21. If loss of aid from the United States were offset by taxing or blocking the remittance of profits by foreign-owned companies, Peru might be able to achieve a rate of 1 to 2 percent in economic growth. The Peruvian government will be reluctant to take such action, however, because of fear of antagonizing other foreign governments and scaring off potential private investors. In either event, output probably would not grow, and might decline, if the Peruvian government further disturbed its economic relations with the United States by expropriating additional US investments.

Long-Term Economic Outlook

22. Peru's economic prospects for the early 1970's would be fairly good if the IPC issue could be settled. Under the stimulus of the expected large inflow of private foreign capital to develop copper and other mineral deposits, the growth of the volume of exports probably could be expanded to 5 to 6 percent annually during 1970-73, compared with an average of 2½ percent annually in 1962-66. This rise would permit Peru to meet the large payments on its external debts (which are scheduled to resume in 1970) without major difficulty. It should also facilitate the recovery of a fairly high rate of economic growth by 1973.

23. If the foreign aid amendments were invoked and remained in force throughout the early 1970's, Peru's rate of economic growth probably would be low, at best. Because the rise in import capacity would be small, total Peruvian output probably would not be able to rise by more than 2 to 3 percent annually on the average, or less than the growth of population. The inflow of official foreign capital would dwindle as undisbursed loan balances with the World Bank and the IDB's loan funds were drawn down. Inflows of private long-term capital probably would be negligible if the repatriation of profits of foreign businesses were blocked. The growth of exports would be slow, being affected adversely by the decline in the value of sugar exports and failure to expand the mining industries owing to the lack of foreign investments. The rise in import capacity also would be restricted by Peru's debt servicing obligations unless Peru defaulted or could re-finance the debt.



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24. Peru is likely to encounter major problems in disposing of its sugar at profitable prices. Because Peru's cost of production usually has been well above the world market price, sugar production has been profitable only because of the premium prices offered by the United States. The prospect, however, for selling sugar at prices above the world market level to other countries such as the USSR is dim.

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25. The stagnation of economic growth would aggravate Peru's unemployment problem. To cope with it, the government might attempt to expand public investments greatly, mainly in fields with small import requirements (road building, for example). Such projects probably could be financed partly with increased taxes on foreign businesses, but substantial government deficits and rising inflationary pressures still would be likely if sizable programs were undertaken.

26. Peru probably would make strong efforts to interest investors in countries such as France or Japan in taking over US-held concessions for further development of deposits of copper and other minerals. Under recent legislation, these concessions can be cancelled if their development is not initiated soon. Efforts to attract capital from other countries are likely to have little success, however, because Peru's international credit rating would be damaged by invocation of the Hickenlooper amendment. At best, Peru might obtain foreign financing for a few small projects, if it offered terms more favorable to the investor than those presently in force for US-held concessions.

27. Peru also probably would seek assistance from the Communist world. In many ways, however, such assistance would be a poor substitute for the US aid that it would lose. The Communist countries are not likely to grant assistance in hard currencies that Peru would need to finance imports from Free World markets. They might offer long-term credits for the financing of imports of capital goods from their own countries and of technical assistance, but other Latin American countries generally have found such offers unattractive. Some Communist equipment is much different from that to which the Peruvians are accustomed

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and might require the presence of Communist technicians in order for it to be useful to Peru. Peru probably would not view with favor the influx of Communist technicians that would be required to make use of large amounts of equipment or to carry out large development projects.

28. The prospective situation in Peru would appear to offer the USSR an opportunity to greatly increase its presence and influence in South America at moderate cost -- the replacement of US aid disbursements of \$70 to \$80 million annually. The full cost, however, of replacing the United States, Western Europe, Japan, and the international lending agencies as sources of capital for Peru would be much larger. Capital inflows from all these sources have averaged between \$150 and \$200 million annually since 1961. The inflow would reach \$300 to \$400 million annually during the next several years, almost entirely from the United States, if aid disbursements were maintained and the planned expansion of the mining industry (which Peru still seems to expect US companies and the Export-Import Bank to finance) were carried out. Assumption of this burden by the USSR would involve aid disbursements comparable to those now required for Cuba, although Peru might be more successful in repaying the credits. Considering the Western orientation and possible instability of Peru's new military government and the danger of provoking strong reactions by Peru's neighbors and the United States, the USSR probably would not provide large-scale aid to Peru. In line with credits previously extended to Brazil, Chile, and Argentina, however, the USSR might offer long-term credits of \$50 to \$100 million, to be drawn down over an extended period of time.